No. 55

In the Supreme Court of the United States

October Term, 1945

The United States of America and Federal Communications Commission, appellants

v.

New York Telephone Company

ON APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR THE UNITED STATES AND THE FEDERAL COMMUNICATIONS COMMISSION

INDEX

CITATIONS

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OPINION BELOW

The opinion of the court below (R. 109–118) is reported in 56 F. Supp. 932–938.

JURISDICTION

The judgment of the court below was entered on January 2, 1945 (R. 118–119). A petition for appeal was filed on February 24, 1945, and was allowed on February 26, 1945 (R. 131–133). On May 7, 1945, this Court noted probable jurisdiction (R. 138). The jurisdiction of this Court on

appeal rests on the provisions of the Urgent Deficiencies Act of October 22, 1913, c. 32, 38 Stat. 219, 220 (28 U. S. C. 47, 47a) as extended by Section 402 (a) of the Communications Act of 1934, c. 652, 48 Stat. 1064, 1093, as amended, c. 229, 50 Stat. 189, 197 (47 U. S. C. 402 (a)).

QUESTIONS PRESENTED

1. Whether the order of the Federal Communications Commission, directing the appellee to charge $4,166,510.57 to its surplus account and to make appropriate concurrent entries on the ground that this amount is an inflationary write-up resulting from transfers between a parent corporation and its controlled affiliate, is consistent with the memorandum filed by the Commission with this Court in *American Telephone and Telegraph Company* v. *United States*, 299 U. S. 232.

2. Whether the Commission's order, applicable to accounting with respect to transactions which took place before the Commission came into existence, and with respect to property some of which has been retired, is nevertheless within the Commission's authority.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Communications Act of 1934 and of the Commission's Rules and Regulations are set forth in the Appendix, *infra*, pp. 53–59.

STATEMENT

This is a suit in equity brought, on February 11, 1944, by the New York Telephone Company against the United States and the Federal Communications Commission to enjoin, set aside, annul and suspend an order adopted by the Commission, on December 14, 1943, requiring the New York Telephone Company to debit the amount of $4,166,510.57 to its Account 413 "Miscellaneous debits to surplus" and to make concurrent entries to other appropriate accounts (R. 1–56). On March 29, 1944, appellants filed a motion for summary judgment, together with the supporting affidavit of Charles R. Denny to which was attached as an exhibit the record of the proceedings before the Commission which had culminated in the issuance of the order in question (R. 57–65, 135).[1] The grounds for the motion were that the complaint and exhibits annexed thereto, the annexed affidavit, and the record of proceedings before the Commission showed that there was no genuine issue

[1] Pursuant to order of the court below, the administrative record (which consists of 3,000 pages and 84 exhibits) has been transmitted to this Court as an original document. The parties have stipulated, subject to the approval of this Court, that the administrative record need not be printed as part of the record but that either party may refer in its brief to any portion thereof and may include in the appendix to the brief such portion of the administrative record as may be deemed relevant (R. 135–136). The pages of the administrative record have been consecutively numbered and reference thereto will be indicated by "Tr."

as to any material facts and that the appellants herein were entitled to judgment as a matter of law. On August 24, 1944, the court below handed down its opinion denying the motion for summary judgment (R. 108–118) and, on January 2, 1945, made findings of fact and conclusions of law (R. 119–130), and entered its judgment and order permanently enjoining, setting aside, suspending and annulling the order of the Commission (R. 118–119).

A. *The parties.*—The appellants are the United States of America and the Federal Communications Commission. The United States is a party because of the requirement of the Act under which the suit is brought. The Federal Communications Commission (hereafter referred to as "the Commission"), created by the Communications Act of 1934, as amended (47 U. S. C. 151, *et seq.*) to administer the provisions of that Act, has jurisdiction over the charges, services, facilities, practices, classifications, and regulations for and in connection with interstate and foreign radio and wire communication service. (R. 120.) From 1910 to 1934, some of the jurisdiction which the Commission now exercises with respect to telephone carriers was vested in the Interstate Commerce Commission (R. 122).

Appellee is the New York Telephone Company, a New York corporation, furnishing telephone exchange and interstate and intrastate message

toll service in the States of New York and Connecticut (R. 120). It is one of the Bell System companies and is thus affiliated with numerous other telephone companies operating throughout the United States. The top holding company of the Bell System is the American Telephone and Telegraph Company (hereafter referred to as "A. T. & T.") which owns 100% of appellee's common stock (R. 121), all or a majority of the capital stock of eighteen other Bell System telephone companies, and a substantial minority of the capital stock of two other Bell System telephone companies; it also owns stock or other financial interests in manufacturing, research, sales, and other companies. In addition to its holding company activities, A. T. & T., through its Long Lines Department, conducts nationwide telephone operations. Certain of the Bell System companies in turn own controlling stock interests or substantial minority interests in other telephone companies.[2]

B. *History of the transfers of the property involved and the accounting therefor.*—Prior to 1925, both New York Telephone Company and A. T. & T. furnished intrastate, as well as interstate, toll service in New York State. In that year, A. T. & T., as part of a plan to withdraw

[2] For a more complete description of the composition of the Bell System, see Report of Federal Communications Commission on Investigation of the Telephone Industry in the United States, 76th Cong., 1st Sess., H. Doc. No. 340, pp. 65–70.

from intrastate toll business in New York State, transferred its intrastate toll business in that state to appellee. In connection with this transfer of business, A. T. & T. made two of the four transfers of property, the accounting for which is involved in this case. These transfers took place in 1925 and 1926, and consisted of outside toll plant, principally poles, wires, and cables. The third toll property transfer involved was made in 1928, when a small amount of toll plant was transferred by A. T. & T. to appellee in connection with the transfer by A. T. & T. to appellee of certain interstate toll business. Much of the property acquired by appellee in these three transfers was in the form of an additional interest in toll plant which, prior to such acquisition, was owned jointly by appellee and A. T. & T. Portions of such acquired property had been originally constructed by appellee for A. T. & T., appellee billing A. T. & T. for the cost of the construction, and A. T. & T. placing the property on its books at that cost. (R. 22–25; Tr. 77–81, 97–99, 103–109, 264, 269–274, 375–376, 429–430, 500–502, 769–770, 771–772, 786, 816, 1308–1311, 1329–1330.) During the same period (1925–1928), toll properties were similarly transferred from appellee to A. T. & T. (R. 23; Tr. 102, 144–146, 373, 500–502, 832).

The fourth property transfer involved in this case took place in 1927 and comprised three es-

sential parts of the telephone stations used by subscribers, theretofore owned by A. T. & T. These parts were the transmitter, receiver, and induction coil, and are designated collectively as "the instruments." The other parts necessary for a complete telephone station, such as the stand, bell box, etc., were owned by appellee. A. T. & T. furnished and maintained the instruments under a "license contract" between it and appellee, similar to that in effect between A. T. & T. and each of its other associated companies. Under this contract, which also covered other matters, appellee paid A. T. & T. a specified percentage of its gross revenues. A. T. & T. decided to transfer to appellee title to the instruments then in the service or in the supplies of appellee, and this was done as of December 31, 1927. (R. 23–24; Tr. 199, 209–212, 526–531, 534–535, 1491–1495, 2316–2317, 2517–2518.)[3]

The above four transfers of property did not involve any change in the physical character of the plant involved, in the service rendered to the public, or in the use of the plant rendering the service. These transactions resulted in shifting to operating costs of appellee certain expenses formerly comprised in operating costs of A. T.

[3] At the same time, A. T. & T. also transferred to its other associated companies ownership of the instruments in their possession (R. 23; Tr. 989–990).

& T., and also in shifting to appellee fixed charges and taxes connected with the ownership of the property. As an offset, appellee retained certain revenues it formerly turned over to A. T. & T. (R. 24; Tr. 212–213, 501–502, 833–834, 2316–2317.)

The amounts involved in each of the above four property transfers are shown in the table set forth below. This table shows with respect to each transfer the book cost to A. T. & T., the related book depreciation and amortization reserves on the books of A. T. & T., and the net book cost to A. T. & T. as of the time when such transfers occurred.[4] The table also shows the amounts at which the property was shown on appellee's books and the "profit" resulting to A. T. & T. from each transaction. See R. 24–25.

[4] As used in the Commission's report, the term "book cost" means the amount at which property is carried (whether rightly or wrongly) in the Company's asset accounts. It may be, in a given instance, the original cost; it may be a price paid which is different from original cost; or it may be some other figure dependent on vagaries of bookkeeping. The term "net book cost" means the book cost minus the amount of depreciation and amortization reserves shown on the books which is related to the property for which the book cost is shown. For the purposes of the report only, it is assumed that the figures in the record for book cost to A. T. & T. of the plant in question represent the original cost of the plant, and that the book depreciation and amortization reserve figures determined by A. T. & T. and shown in the record as applicable to the plant transferred to New York are correct. (R. 24, notes 5 and 6.)

Property Group	Book cost to A. T. & T.	Related depreciation and amortization reserves	Net book cost to A. T. & T.	Recorded book cost to New York Telephone Co.	Excess or "Profit" to A. T. & T.
1925—Toll line Property	$5,010,340.19	$801,858.95	$4,208,481.24	$5,831,884.78	$1,623,403.54
1926—Toll line Property	95,924.66	14,449.20	81,475.46	97,310.39	15,834.93
1928—Toll line Property	28,077.64	4,144.78	23,932.86	44,246.30	20,313.44
1927—Telephone instruments	8,135,224.98	3,980,944.73	4,154,280.25	6,661,238.91	2,506,958.66
Total	13,269,567.47	4,801,397.66	8,468,169.81	12,634,680.38	4,166,510.57

In recording on its books each of the above four property transfers, A. T. & T. credited its plant account with the amount of its book cost shown in the above table, and debited its depreciation and amortization reserves with the amount shown for those reserves in the table. On the other hand, appellee, in each case, recorded the transfer by entering in its plant accounts the total amounts of the "prices" assigned for the properties acquired, but recorded no amount with respect thereto in its depreciation or amortization reserve accounts. In each of the four cases, the amount recorded by A. T. & T. as received from New York in excess of the net book cost to A. T. & T. of the plant transferred was credited by A. T. & T. to surplus accounts as profit on the transaction. These excess amounts, or "profits", totaled $4,166,510.57. (R. 25; Tr. 112–116, 134, 244–248, 254–259, 290–291, 361, 369–370, 473, 478–479, 483–484, 2280, 2284–2287.) As has been pointed out (*supra*, p. 6) appellee, during the period of the transfers involved here, also transferred some property to

A. T. & T. Some of this property was taken over by A. T. & T. at a figure in excess of the net book cost to appellee. Thus, as a result of mutual transfers, both A. T. & T. and appellee realized profit on their books. (R. 23, 29; Tr. 144–146, 373, 500–502.)

The difference of more than four million dollars between the net book cost to A. T. & T. of the properties transferred and the amounts recorded in the books of appellee is attributable to the facts that the original cost of the property transferred, and the depreciation which had been accrued therefor on the books of A. T. & T. to the date of transfer, were ignored. With respect to the three transfers of toll properties, the "price" was allegedly determined on the basis of "structural value" as of the time of the transfers, or estimated reproduction cost new minus a depreciation allowance, as determined by appraisals. (R. 25; Tr. 87–96, 121–126, 362–370.) The recorded cost to appellee of the instruments was based upon the average price of new instruments purchased by A. T. & T. from the Western Electric Company (a subsidiary of A. T. & T.) during the first nine months of 1927, less 20% which allegedly accounted for the used condition of the instruments. (R. 25; Tr. 534–535, 542, 555–557, 996–997, 1116–1118, 1124, 1136–1140, 2316–2317.)

Appellee entered no amount in its depreciation or amortization reserves at the time of transfer. Thereafter, it made regular annual accruals to

depreciation reserve. The amount of these entries was determined by applying to the "price" paid for the property as recorded on its books the current depreciation rates which appelleee had theretofore established with respect to the several classes of plant involved. In the case of the toll property, appellee already had property of this kind in its accounts, and it recorded the transferred property in those accounts and thereafter used the depreciation rates previously applied to amounts in such accounts. (R. 26; Tr. 121–126, 362–366, 473.) So far as the instruments were concerned, appellee had had no property of this kind before the 1927 transfer. The depreciation factor applied was that which appellee had established for the station equipment it did own based on data through the year 1925, this being done on the assumption that the remaining service life of the instruments was the same as that of the other station equipment. (R. 26; Tr. 548–554; 558–563, 1009–1010, 1018, 1022, 1036–1048, 1140–1141.)

From time to time, appellee retired portions of the acquired property from service. When this was done, estimated amounts, based upon the book cost (i. e., "price") to appellee of the property, were retired on its books by credits of such amounts to its plant accounts. At the same time, appellee debited corresponding amounts (with allowance for salvage) to its depreciation or amortization reserves. This was done although the property acquired by appellee which had already been

used by A. T. & T., was transferred at prices which purported to reflect all existing depreciation, and appellee had not thereafter applied any special depreciation rate nor made any entry in its depreciation reserve for the existing depreciation. Hence, appellee never credited its depreciation reserve with the full amount it debited thereto when it retired the property. (R. 25–26; Tr. 1198–1199, 1527, 1532–1534, 1970–1972, 1986–1988.)

In July 1934, pursuant to the Communications Act, jurisdiction with respect to the accounting followed by the New York Company was transferred from the Interstate Commerce Commission to the Federal Communications Commission (R. 124). On January 1, 1937, following the decision of this court in *American Telephone and Telegraph Company* v. *United States*, 299 U. S. 232, the Commission's Uniform System of Accounts for Class A and Class B Telephone Companies became effective [5] and its provisions are applicable

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[5] This System of Accounts is contained in Part 31 of the Commission's Rules and Regulations. A copy of these Rules and Regulations is being filed with the Clerk for the convenience of the Court.

On June 19, 1935, the Commission adopted its Order No. 7–C which prescribed a Uniform System of Accounts for Telephone Companies having average annual operating revenues exceeding $50,000, effective January 1, 1936 (1 F. C. C. 45). The operation of Order No. 7–C was stayed because of the proceeding in the case of *American Telephone and Telegraph Company* v. *United States*, in which the validity of this Uniform System of Accounts was attacked by the

to appellee as a Class A telephone Company. A key provision of this System of Accounts is the requirement that telephone companies set up or reclassify their investment accounts (Accounts 100.1 to 100.4—Secs. 31.100:1–31.100:4) on the basis of original cost. "Original cost" is defined (Sec. 31.01–3 (x)) as "the actual money cost of * * * property at the time when it was first dedicated to the public use, whether by the accounting company or by predecessors." The system further provides that Account 100.4 (Sec. 31.100:4), "Telephone plant acquisition adjustment," shall include amounts 'representing the difference between (1) the amount of money actually paid * * * for telephone plant acquired, plus preliminary expenses incurred in connection with the acquisition; and (2) the original cost of such plant, governmental franchises and similar rights acquired, less the amounts of reserve requirements for depreciation and amortization of the property acquired."

Appellee did not reclassify on an original cost basis the amounts in its accounts associated with

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American Telephone and Telegraph Company, the New York Company, other Bell System Telephone Companies, and certain other telephone companies. After the decision of the Supreme Court of the United States on December 7, 1936 (299 U. S. 232), sustaining the validity of the Commission's Uniform System of Accounts, the Commission adopted its Order No. 7-D which amended Order No. 7-C in certain respects and made the amended System of Accounts effective January 1, 1937 (3 F. C. C. 9).

the transfer of the telephone instruments in 1927 (R. 27; Tr. 143, 149, 193–194, 204, 484–485). It did purport to reclassify its accounts, as of January 1, 1937, for the toll plant transferred to it by A. T. & T. in 1925, 1926, and 1928, and it placed $483,975.83 in Account 100.4.[6]

In 1938, appellee began amortizing the amounts included in its Account 100.4 by charges and credits to its operating expense Account 614 (Sec. 31.614), "Amortization of telephone plant acquisition adjustment", with concurrent entries to its Account 172 (Sec. 31.172), "Amortization re-

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[6] Appellee reclassified its accounts by estimating the book cost to it of the toll plant which still survived as of 1937. Next, the original cost of such surviving plant, as originally reflected on the books of A. T. & T., i. e., book cost to A. T. & T., was determined. The latter figures were set up in Account 100.1 of appellee to represent the amount of such surviving property as "plant in service." The difference between this "original cost" and the book cost to appellee was placed in Account 100.4. This amount was $483,975.83. No amount was credited to appellee's Account 171 (Sec. 31.171), "Depreciation reserve," in the process of reclassification. (R. 27; Tr. 116–120, 131–133, 146–147, 248–249, 473–475, 1279–1283, 1288–1293, 2281, 2282.)

In connection with appellee's plan for disposition of amounts included in Account 100.4, it transferred, in 1937, from its Account 171 to its Account 172 (Sec. 31.172), "Amortization reserve," an amount which, when supplemented by future accruals over the estimated remaining life of the plant at the then current depreciation rates for the respective plant classes, would provide a reserve equivalent to the amount in question in Account 100.4 at the termination of the life of the property involved (R. 27; Tr. 147–149, 249–250, 474, 1293–1294, 2283). For the disposition which the Commission made of this amount placed in the "Amortization reserve", see R. 41–42.

serve". From time to time, when portions of the acquired plant were retired, amounts in Account 100.4 were written out of that account with a concurrent entry to Account 172. Such amortization charges to Account 614 were suspended by the Commission's order of June 16, 1942. (R. 47, 48, Tr. 120, 149.)

C. *Proceedings before the Commission.*—On June 16, 1942, the Commission adopted an order instituting a general investigation into the accounting performed and the accounts, records and memoranda kept by appellee at the time of and during the period since the four transfers of property involved in this suit. Appellee was required to show cause why the amount of $4,166,510.57 should not be charged to its Account 413 (Sec. 31.413), "Miscellaneous debits to surplus," with concurrent entries to such accounts as may be appropriate. As has been noted, the order of June 16, 1942, also suspended all charges to operating expense accounts made by appellee on and after January 1, 1942, for the purpose of or in conjunction with amortizing or otherwise disposing of amounts included in its Account 100.4, "Telephone plant acquisition adjustment", pending submission of proof by appellee of the propriety and reasonableness of such charges. (R. 47–49.)

A hearing was ordered to be conducted jointly with any hearings involving similar matters which might be ordered for the same time and place by the Public Service Commission of New York and

the Connecticut Public Utilities Commission. Joint extensive hearings were held before two Commissioners of the Federal Communications Commission and two Commissioners of the New York Public Service Commission. Appellee participated and presented evidence at these hearings. Evidence was also submitted by members of the staff of both Commissions and by witnesses called on behalf of both Commissions. (R. 22, Tr. generally.)

On January 19, 1943, appellee filed its proposed findings of fact and conclusions and supporting brief with the Commission (R. 22, Tr. 2719–2809). On June 22, 1943, the Commission issued its proposed report in which it concluded that the amount of $4,166,510.57 should be charged to Account 413, "Miscellaneous debits to surplus", with concurrent entries to appropriate accounts specified in the proposed report (R. 65–76). On July 16, 1943, appellee filed exceptions to the Commission's proposed report, together with a supporting brief, and requested oral argument before the Commission (Tr. 2822–2906, R. 77–107). Oral argument was held before the Commission *en banc* on September 22, 1943 (Tr. 2920–2963), and on December 14, 1943, the Commission issued its final report and order (R. 20–43).[7]

[7] On December 14, 1943, the New York Public Service Commission also adopted its final report and reached the same conclusions as did the Commission (R. 22, Tr. 2990–3031).

The Commission held that the accounting performed by appellee with respect to the four property transfers involved was improper and resulted in a purely inflationary write-up of its plant accounts to the extent of the amounts entered therein in excess of the net book cost to A. T. & T. of the property. The Commission further held that the inflation was not removed by the fact that some of the property transferred had been retired. As to the retired property, the inflation remained in the form of a deficiency in the depreciation reserve account, since the debit to the depreciation reserve of the entire book cost (to appellee) of the property retired was made despite the fact that insufficient credits had been made to the reserve account for purposes of retirement of the property. The Commission also held that, contrary to appellee's contention, the Interstate Commerce Commission's rules in effect at the time of the transfer did not require the accounting performed by New York, and that, in any event, the Federal Communications Commission was not bound by the accounting rules prescribed by the Interstate Commerce Commission. Finally, the Commission held that the supplemental memorandum presented to the Court by the Federal Communications Commission in the case of *American Telephone and Telegraph Company v. United States*, 299 U. S. 232, could not be construed as preventing the Commission from requiring ap-

pellee to write out of its surplus account the amount of inflation which the Commission found in this case to exist in appellee's accounts. (R. 22-40.)

The Commission's order, accompanying the final report, directed appellee to debit the amount of $4,166,510.57 to its Account 413, "Miscellaneous debits to surplus," and to make appropriate concurrent entries to accounts specified in the order (R. 41-43).

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

(1) In denying appellant's motion for summary judgment.

(2) In issuing the injunction prayed for by appellee.

(3) In holding that the Federal Communications Commission was without power to promulgate the order sought to be set aside by appellee, and in failing to hold that the Federal Communications Commission had authority to promulgate the said order.

(4) In holding that the action of the Commission in requiring the New York Telephone Company to write off from its accounts, amounts paid by it to American Telephone and Telegraph Company for property acquired from that company in excess of the net book cost of the property to that company at the time of the purchase did not constitute a fair consideration of all the circum-

stances and was not a valid determination that such excess was not a true increment of value within the meaning of the supplemental memorandum filed by the government in the case of *American Telephone and Telegraph Company* v. *United States*, 299 U. S. 232, and that the Commission's action was therefore in violation of the terms of that supplemental memorandum.

(5) In holding that the accounting entries here involved were made in compliance with then applicable rules and regulations of the Interstate Commerce Commission.

(6) In holding that the order of the Commission is invalid because it sought to apply retroactively the Federal Communications Commission's System of Accounts to write down appellee's surplus by requiring changes in certain accounting entries originally made by appellee in accordance with regulations of the Interstate Commerce Commission.

SUMMARY OF ARGUMENT

I

The order of the Commission here challenged is in conformity with the supplemental memorandum filed by the Government in *American Telephone and Telegraph Company* v. *United States*, 299 U. S. 232. That memorandum and the opinion of this Court in that case make it clear that it was contemplated that the Commission would decide whether, in a particular case, amounts carried on the books of a corporation

represented a "true investment". There is an abundance of evidence to support the Commission's determination here that a company makes no such "true investment" when the transfer is between a parent and its controlled affiliate. Such a transaction is essentially identical with the situation created when a company writes up the value of its properties on its own books.

Having found that the amount recorded on appellee's books with respect to the properties transferred, over and above their net book cost to the transferor, was not related to any additional investment, the Commission properly required the carrier to remove from its books increments of value claimed to have been recognized at the time of the transfer. *Colorado Interstate Gas Company* v. *Federal Power Commission,* 324 U. S. 581, rehearing denied, April 30, 1945, No. 379, 1944 Term.

II

The order is valid and within the Commission's authority although it applies to accounting with respect to transactions which took place before the Commission was in existence. Whether or not the original accounting here involved was in accordance with the Interstate Commerce Commission's system of accounts in effect at the time of the transfers in issue, the Commission possesses the authority, under Section 604(a) of the Communications Act of 1934, to supersede the Interstate Commerce Commission's system of accounts

and to require the company to restate its accounts. *American Telephone and Telegraph Company* v. *United States, supra.* Thus, where the accounting with respect to a transaction long since past continues to have present and future significance, the Commission may continue to exercise its jurisdiction and to inquire whether such accounts are properly stated. When the Commission finds that they are not properly stated and requires appropriate adjustment, it is not imposing a penalty for a failure in the past to record the transaction in conformity with a system of accounts not then in existence but is rather requiring the restatement of existing balances, as they are affected by these past transactions, so that these balances may be accurately stated.

III

In this case, the accounting performed with respect to the transfer between A. T. & T. and appellee presently results in a misstatement still reflected in the accounts, although some of the property has already been retired. The record clearly shows that there is such a misstatement. The depreciation of the property which appellee acquired from A. T. & T. was accounted for by appellee at annual rates which did not take into consideration the fact that the property was partly depreciated at the time of its acquisition, and was entered on its books at a figure which purported to reflect existing depreciation, with nothing be-

ing included in the depreciation or amortization reserves with respect to the property. As a result, when the property reached the end of its service life, insufficient amounts had been accumulated in appellee's depreciation reserve to cover the cost of the property as carried in appellee's plant accounts. Thus, when the property in question was retired and appellee's book cost of the property was credited to plant account and the same amount was debited to depreciation reserve, appellee charged to the depreciation reserve more than had been credited thereto; the excess being at least as much as the amount of the write-up with respect to that property. This resulted in moving the inflation from the plant accounts to the depreciation reserve in the form of a deficiency in the reserve. Under this type of accounting, the retirement of property could not possibly have removed any of the inflation which was introduced into the accounts when the transfers took place.

ARGUMENT

I

THE COMMISSION'S ORDER IS CONSISTENT WITH THE SUPPLEMENTAL MEMORANDUM FILED BY THE GOVERNMENT IN *AMERICAN TELEPHONE AND TELEGRAPH COMPANY V. UNITED STATES*, 299 U. S. 232

The court below held that the Commission's order violates the terms of the supplemental memorandum filed by the government in *American Telephone and Telegraph Company* v. *United*

States, 299 U. S. 232. Before discussing this point a brief statement of the history and nature of the Commission's Uniform System of Accounts and of the litigation following its adoption may be helpful.

The Federal Communications Commission is authorized by Section 220 (a) of the Communications Act of 1934 (47 U. S. C. 220 (a)) to prescribe, in its discretion, forms of accounts for carriers subject to its jurisdiction. Under Section 220 (c), when the Commission questions an accounting entry made by a carrier, the burden of proof is on the carrier to justify the entry in question. The Commission's Uniform System of Accounts became effective on January 1, 1937. This system of accounts is an "original cost" system, unlike the system of accounts which had been prescribed by the Interstate Commerce Commission. Hence, appellee was required to reclassify its accounts on an original cost basis. In brief, this required appellee to record in Account 100.1 ("Telephone plant in service") the "actual money cost of * * * property at the time it was first dedicated to the public use, whether by the accounting company or by predecessors" and to record in Account 100.4 ("Telephone plant acquisition adjustment") amounts "representing the difference between (1) the amount of money actually paid * * * for telephone plant acquired, plus preliminary expenses incurred in

connection with the acquisition; and (2) the original cost of such plant, governmental franchises and similar rights acquired, less the amounts of reserve requirements for depreciation and amortization of the property acquired."

When the Commission's Uniform System of Accounts was promulgated, and before it became effective, suit was filed by appellee, A. T. & T., and other telephone companies to set it aside. Among other contentions, the argument was made that the system of accounts was unlawful on the ground that the amounts in Account 100.4, representing the difference between the price paid for property and original cost of that property when first dedicated to the public use, would have to be written off summarily by the carrier without any opportunity to amortize such amounts by charges to operating expenses. The Commission asserted that this was an incorrect interpretation of the provisions of Account 100.4. In order to clarify this and other points raised by the telephone companies, the Government, at the request of this Court, submitted a supplemental memorandum which reads as follows with respect to Account 100.4 (R. 46):

> (1) That amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value will be retained in that account until

> such assets cease to exist or are retired; and, in accordance with paragraph (C) of account 100.4, provision will be made for their amortization.
>
> (2) That when amounts included in account 100.4 are deemed, after a fair consideration of all the circumstances, to be definitely attributable to depreciable telephone plant, provision will be made for amortization of such amounts through operating expenses, through the medium of either account 613 (R. 196) or account 675 (R. 205).

The Court accepted the supplemental memorandum as a binding construction by the Commission. With respect to the supplemental memorandum, and in answer to the contention that amounts in Account 100.4 would in all cases have to be summarily written off, this Court said (p. 240–241):

> The Commission is not under a duty to write off the whole or any part of the balance in 1004, if the difference between original and present cost is a true increment of value. On the contrary, only such amount will be written off as appears, upon an application for appropriate directions, to be a fictitious or paper increment. This is made clear, if it might otherwise be doubtful, by administrative construction.

In the instant case, the Commission found that the amount by which the so-called prices which appellee paid to its parent company, A. T. & T.,

exceeded the net book cost of that property to A. T. & T. merely represented a "fictitious or paper increment" within the meaning of this Court's opinion in *A. T. & T.* case because it resulted from purely formal transactions between parent and subsidiary incapable of bargaining at arm's length.[8] As the Commission stated in its report (R. 28–29):

> This accounting resulted in a purely inflationary write-up of New York's plant

[8] Many witnesses experienced in the field of regulation of public utility accounting testified before the Commission that when property is transferred from a parent to a controlled affiliate, proper accounting requires that the property be entered on the books of the affiliate on the same basis, as to plant account and depreciation reserve, as it was carried on the parent's books. These witnesses were Mr. William Norfleet, Chief Accountant of the Federal Communications Commission (Tr. 1608–1613, 2023–2024, 2026–2029, 2035–2036, 2041, 2082–2085); Mr. Henry Long, Chief of the Accounting Regulations Division of the Federal Communications Commission (Tr. 1179–1185, 1192–1199, 1202–1206, 1207–1210, 1929–1933); Mr. Charles W. Smith, Chief of the Bureau of Accounts, Finance and Rates of the Federal Power Commission (Tr. 1593–1602, 1627–1631, 1952–1954); Mr. Clyffe Crandall, Director of the Bureau of Accounts of Interstate Commerce Commission (Tr. 1170–1177, 1559–1560, 1562–1564, 1567–1575); and Mr. Malcolm F. Orton, Director of Research and Valuation of the New York Public Service Commission (Tr. 1721–1727, 1985). See also, Montgomery, *Auditing Theory and Practice*, as quoted in Tr. 1508–1510, 1619–1622. Although appellee produced witnesses who testified that in their opinion the accounting followed by appellee was proper, it is significant that they did not state that the type of accounting prescribed by the Commission's order is at all improper. Indeed, as early as 1914 and continuing throughout the period of the transfers in question and up to 1934,

> accounts by the amounts entered therein in excess of the net book cost to A. T. & T. of the plant involved. These excess amounts represented a "profit" to A. T. & T. Since New York was then, as it is now, fully subject to control by A. T. & T., the inter-company profits to A. T. & T. resulting from the affiliated company transfers of property involved herein are fictitious or paper increments, and are as unreal as profits from interdepartmental transactions.

Accordingly, the Commission found that the amount of these write-ups had no place in the appellee's accounts.[9]

The court below held (R. 117) that this finding by the Commission was erroneous because the

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the Bell System companies themselves, including appellee, were taking the position before the Interstate Commerce Commission that it was proper accounting to use the transferor's book figures as the basis for accounting for intra-system affiliated company transfers (R. 34, Tr. 495, 727–728, 732–733, 747–749, 752–754, 2264–2265, 2339–2378). Of about 37,200 Bell System acquisitions of property in the period 1916 to 1935, totalling more than $680,000,000 in consideration paid, the great majority of the transactions, aggregating about $478,000,000, were accounted for by the transfer of amounts in the transferor's plant and reserve accounts to the corresponding accounts on the books of the acquiring company (Tr. 495, 2264–2265).

[9] Accounting witnesses called by the Commission testified that there was no objection to using Account 100.4 for control purposes; that there was no objection to the amount of the fictitious increment finding temporary resting place there, so long as it was immediately written off (Tr. 1599–1601, 1612, 1668–1676, 1693–1697, 1726–1727, 2040, 2042, 2091–2092).

Commission was required by the supplemental memorandum filed by the government in *American Telephone and Telegraph Company* v. *United States,* 299 U. S. 232, to determine whether the difference between original cost and the price claimed to have been paid is a true increment of value and that the Commission's finding that the difference did not represent a true increment of value because it resulted from a transaction between a parent and its controlled affiliate did not constitute such a determination. The court did not indicate the nature of the determination which the Commission would be required to make in this type of case, but judging from its reliance (R. 117, 122) on the fact that the Commission had made no determination of the value of the property at the time of the transfer, it seems clear that the court below was of the opinion that the Commission could not require a write-off of the amounts in question without undertaking a valuation of the property transferred in order to determine whether appellee paid more for the property than it was worth.

The fallacy in the court's reasoning lies in its attempt to treat the accounting for transactions between a parent and its controlled affiliate in exactly the same way that bona fide arms' length transactions between independent parties might be treated. Apart from the question of what consideration the Commission may be required to

give to value with respect to the accounting for a transaction between independent parties in determining whether any excess of purchase price over original cost represents an investment in assets of continuing value, to require a consideration of value in cases involving transactions between a parent and its controlled affiliate would make an idle gesture of an original cost system of accounts. For example, if instead of a transfer between a parent and an affiliate, a corporation simply wrote up the assets on its books or transferred the assets from one department to another department at a figure higher than original cost, the Commission would certainly not be required to go through a valuation proceeding before requiring the amount of the write-up to be stricken from the books. Whether or not the property had appreciated in value would not be relevant. To hold that a different result is required simply because the transfer is not from one department of the company to another but is to a separate controlled corporation is to exalt form at the expense of substance. Such a rule would permit corporations, by the simple device of making transfers to wholly owned subsidiaries, to increase the amounts at which the property is carried on their books, and make the Commission powerless to compel appropriate accounting adjustments without costly, time-consuming and extensive valuation proceedings to determine the

value of the property. Valuation questions are conjectural enough even when the parties are dealing at arms' length (*Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 599–609); the absence of arms' length bargaining renders such questions completely unrealistic.[10]

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[10] In discussing similar contentions of appellee in the proceedings before the Commission, the Commission stated in its Report (R. 30–31):

"All of these contentions ignore the important fact that New York was and is a wholly owned subsidiary of A. T. & T., and therefore fully subject to A. T. & T.'s control. This fact makes the fairness and reasonableness of the "prices" paid in such a transfer of property between such affiliated companies completely unrealistic as a measure of investment in plant. There was and could be no arms'-length bargaining between A. T. & T. and New York with respect to the amounts so paid. Any method of accounting which results in the inclusion in plant investment accounts of amounts based upon 'values' agreed upon between a wholly owned subsidiary and its parent which are greater than legitimate net book cost to the transferor would nullify accounting from a regulatory standpoint. The full ultimate impact of such inflationary elements in the plant accounts is in time improperly reflected in the depreciation expense account as an alleged operating cost, unless, by proper regulatory requirements, the balance sheet is cleared, or in the first instance is kept free, of such inflationary elements. Accounting, for purposes of efficient regulation of public utilities, must be firmly grounded on the cost principle, and if the investment recorded in the accounts is to have some relationship to the actual investment dedicated to the public use by an affiliated group of companies, such agreed 'values' must not be allowed to exist as a distortive element in their investment accounts. Certainly such 'values' cannot be represented by an estimate of such an inherently speculative nature as reproduction cost less depreciation, or 'structural'

The absurd extent to which such a practice could lead is demonstrated by the facts of this case. As has been pointed out, during the period when A. T. & T. transferred the property involved in this suit to appellee, appellee also transferred other property to A. T. & T. As in the transfers involved in this suit, some of the transfers from appellee to A. T. & T. were at a price higher than the original cost to appellee. With no increase in property, and with no change in service, the combined surplus of the companies was increased. Thus, while no one would contend that A. T. & T. or appellee could by their own action properly write up the value of these assets on their own books, by the simple device of having A. T. & T. and appellee exchange ownership in certain property, the same write-up is achieved. If such a practice were permitted it would make the original cost system of accounts largely ineffective in the telephone field in which a large part of the business is in the hands of companies under common control (see *American Telephone*

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value.' Otherwise transfers of property between affiliated companies would provide a device to establish write-ups to any desired 'structural value.' 'Structural value' at best requires conjecture, involving as it does estimates as to what certain property might have cost to reproduce, assuming it were to be reproduced in new condition at the prices in effect at the time when the estimates are made; and further involving estimates as to existing depreciation in the property, based on obsolescence and inadequacy, as well as wear and tear."

and Telegraph Co. v. *United States,* 299 U. S. 232, 238–239).

This Court, in the *American Telephone and Telegraph* case, made it perfectly clear that it did not propose to "define or catalogue" the circumstances under which a write-off of items in Account 100.4 would be permissible. All that this Court was there called upon to decide was the propriety of the segregation of certain items into Account 100.4. The Court had no need to, and did not, decide whether the price paid on an acquisition of property may be disregarded when the parties to the transaction are parent and subsidiary. This Court left to the Commission the power to determine when a company has made a "true investment" (299 U. S. at 242), and there is an abundance of evidence in this record (see *supra*, note 8, pp. 26–27) to sustain the Commission's determination that appellee made no such "true investment" when it paid its parent more than four million dollars in excess of the net book cost of the property to A. T. & T. It was entirely within the Commission's discretion to decide that the affiliation between A. T. & T. and appellee required non-recognition of the profit which resulted from the transfers in question. Given the facts of affiliation and control, the Commission, endowed with a special competence, and charged with the duty of determining whether appellee's accounts reflect a fictional investment, was free

to infer from these facts, and these facts alone, that the increment on appellee's books was merely an inflationary write-up. Cf. *National Labor Relations Board* v. *Regal Knitwear Co.*, 140 F. 2d 746, 747 (C. C. A. 2), affirmed, 324 U. S. 9; see also *Republic Aviation Corp.* v. *National Labor Relations Board*, decided by this Court on April 23, 1945, slip opinion, pp. 4–5; see also cases cited *infra*, p. 34, note 11.

The recent decision by this Court in *Colorado Interstate Gas Company* v. *Federal Power Commission*, 324 U. S. 581, rehearing denied, April 30, 1945, No. 379, 1944 Term, supports the Commission's interpretation of the *American Telephone and Telegraph Company* case. That case involved a transfer of certain oil-producing properties between affiliated companies controlled by the same holding company at a price which the parties contended represented the fair value of the property but which exceeded the original cost of the property. It was argued that there had been a real appreciation in property values and that the Federal Power Commission was without authority to require exclusion of the amount of the write-up from the rate base of the company to which the transfer was made. This argument was rejected by this Court, which held that the Federal Power Commission had ample authority to require the amount of the write-up to be eliminated from the

rate base.[11] The Court said (324 U. S. at 607–608):

> Canadian contends that the Commission should have included $5,000,000 in the rate base for the gas leases and producing properties acquired from Amarillo. The original cost of the properties to Amarillo was $1,879,504. That is all the Commission allowed. It said, "Any treatment which would permit the capitalization of such amounts would open the door to the renewal of past practices of the utility industry when properties were traded between affiliated interests at inflated prices with the expectation that the public would foot the bill." 43 P. U. R. (N. S.) p. 215.

[11] The lower federal courts have consistently sustained the authority of the Federal Power Commission to require the elimination of profits resulting from transfers of property between affiliated companies. *The California Oregon Power Co.* v. *Federal Power Commission*, 150 F. 2d 25 (C. C. A. 9); *Pennsylvania Power & Light Co.* v. *Federal Power Commission*, 139 F. 2d 445 (C. C. A. 3); *Niagara Falls Power Co.* v. *Federal Power Commission*, 137 F. 2d 787 (C. C. A. 2), certiorari denied, 320 U. S. 792; *Alabama Power Co.* v. *Federal Power Commission*, 134 F. 2d 602 (C. C. A. 5); *Louisville Gas & Electric Co.* v. *Federal Power Commission*, 129 F. 2d 126 (C. C. A. 6), certiorari denied, 318 U. S. 761; *Alabama Power Co.* v. *Federal Power Commission*, 128 F. 2d 280 (App. D. C.), certiorari denied, 317 U. S. 652; *Northern States Power Co.* v. *Federal Power Commission*, 118 F. 2d 141 (C. C. A. 7); *Alabama Power Co.* v. *McNinch*, 94 F. 2d 601 (App. D. C.). See also *Natural Gas Pipeline Co.* v. *Slattery*, 302 U. S. 300, 307; *Western Distributing Co.* v. *Public Service Commission of Kansas*, 285 U. S. 119, 124; *United Fuel Gas Co.* v. *Railroad Commission of Kentucky*, 278 U. S. 300, 310.

We agree. Southwestern owned the producing properties at the beginning of the transaction through one subsidiary; it owned them at the end of the transaction through another subsidiary. As between Southwestern and its subsidiaries there was no more than an intercompany profit. * * * The end result is that property has been transferred at a write-up from one of Southwestern's pockets to another. The impact on consumers of utility service of write-ups and inflation of capital assets through intercompany transactions or otherwise is obvious. The prevalence of the practice in the holding company field gave rise to an insistent demand for federal regulation. See S. Doc. No. 92, Pt. 84–A, 70th Cong., 1st Sess. Utility Corporations, Final Report of the Federal Trade Commission (1936); Bonbright & Means, The Holding Company (1932), ch. VI; Barnes, The Economics of Public Utility Regulation (1942) pp. 95 *et seq.*

American T. & T. Co. v. *United States*, 299 U. S. 232, is not opposed to our position. It merely indicates a proper treatment of an intercompany transaction where in fact an additional investment is shown to exist.

The inter-affiliate transactions involved in the instant case fall perfectly into this description by the Court of a purely inflationary write-up. Here, as in the *Colorado Gas Company* case, property has been transferred between controlled compa-

nies at a price in excess of original cost of that property to the transferor. In this case, as in the *Colorado Gas Company* case, the companies contend that the property was in fact worth what the controlled subsidiary paid for it. The elimination by the Federal Power Commission of the write-up in the *Colorado Gas Company* case was held to be consistent with this Court's opinion in the *American Telephone and Telegraph Company* case. On the same reasoning, the action of the Federal Communications Commission here challenged was proper.

II

THE COMMISSION'S ORDER IS VALID EVEN THOUGH IT APPLIES TO ACCOUNTING WITH RESPECT TO TRANSACTIONS WHICH OCCURRED BEFORE THE COMMISSION CAME INTO EXISTENCE

The court below held that the accounting performed by appellee at the time the transfers in question took place was in accordance with the rules of the Interstate Commerce Commission and that the Federal Communications Commission could not retroactively change those rules. The accounting for the specific transactions in question, however, was never submitted to the Interstate Commerce Commission for a ruling, nor was any ruling ever made by the Interstate Commerce Commission with respect to the accounting therefor.[12] Although the Communications Commission,

[12] The evidence showed that beginning as early as 1914, shortly after the Interstate Commerce Commission's system

in its report, held (R. 32–34) that appellee's accounting was not required or authorized by the then applicable rules of the Interstate Commerce Commission, the Government does not consider a ruling on this point essential to the proper disposition of the case. The Commission's report (R. 34) makes it clear that the Commission did not consider itself bound by the accounting requirements of the Interstate Commerce Commission and felt free to impose new and different requirements when it was thought necessary to do so. The court below denied that the Commission had such authority.[6]

It is difficult to reconcile this holding of the court with the express provisions of the Com-

of accounts became effective, and continuing throughout the period when the transfers involved in this case took place, and up until 1934, the Bell System companies, including appellee, repeatedly requested, and received, from the Interstate Commerce Commission rulings that it was proper to account for acquisitions of the type involved here by transferring the book figures of the transferor to the books of the transferee. These cases represented the great bulk of the property involved in all intra-Bell System transfers; of about 300 intra-Bell System transfers of property in the period 1913–1932, involving charges to plant accounts of $50,000 or more, about 170 of the cases were transfers on the basis of the transferor's book figures. Although the evidence shows that other intra-Bell System transfers like the one involved in this case were made on some basis other than the transferor's book costs, none of these transfers of property was ever presented to the Interstate Commerce Commission for a ruling nor was any ruling ever given thereon by the Interstate Commerce Commission (R. 33, 34; Tr. 495, 707–708, 727, 729, 732, 734, 747, 749, 752–754, 1176–1177, 1579, 1582, 2264–2265, 2339–2378). Cf. note 8, pp. 26–27, *supra*.

munications Act., Section 604 (a) of the Communications Act, *infra,* p. 54, specifically provides that the orders, determinations, rules and regulations of the Interstate Commerce Commission shall remain in effect only until they are modified, terminated, superseded or repealed by the Federal Communications Commission. The Commission, by Section 220, is expressly authorized to prescribe a uniform system of accounts, and clearly can prescribe a system of accounts different from that which was prescribed by its predecessor, the Interstate Commerce Commission. Since accounting entries record past transactions, they must inevitably concern matters which are irretrievably past. But the significance and utility of books of account are necessarily present and prospective; and the books are intended for the present and future guidance not only of the regulatory agencies, but of investors, creditors, and the public. "The very object of a system of accounts is to display the pertinent financial operations of the company, and throw light upon its present condition" (*Kansas City Southern Ry.* v. *U. S.,* 231 U. S. 423, 440). A carrier subject to regulatory control, therefore, acquires no vested right in the system of accounting which prevailed at the time a particular transaction took place. If this were not so, a continuing regulatory jurisdiction over accounting practices would be wholly robbed of significance.

When the Federal Communications Commission adopted its Uniform System of Accounts based upon original cost, it adopted a system different in important respects from that which had been prescribed by the Interstate Commerce Commission. As a result, carriers were required to reclassify their accounts on the basis of the original cost provisions of the new system of accounts. This meant that some of the accounting with respect to certain transactions which had been entered into by telephone companies in the past, in accordance with the applicable rules of the Interstate Commerce Commission, had to be adjusted to conform to the System of Accounts of the Federal Communications Commission. The Commission's right to require such changes was one of the issues in the *American Telephone and Telegraph Company* case, and the Commission's authority was expressly sustained by the decision of the Court in that case.

On analysis, the district court's holding of retroactivity seems to be based on a misapprehension; it seems to have had the impression that the Federal Communications Commission was attempting to impose a penalty for appellee's past failure to keep accounts in accordance with a standard not then existing and only subsequently prescribed by the Federal Communications Commission. This is evident from the citation by the court below of the decision in *Arizona Grocery Company* v. *Atchison, Topeka and Santa Fe Rail-*

way Company, 284 U. S. 370. In that case the Interstate Commerce Commission, in making a reparation award, held a rate to be excessive which was in compliance with a previous Interstate Commerce Commission ruling issued when the charge in question was originally made. In setting aside the Commission's order, the question on which this Court there divided was whether the Commission was without authority thus to impose a liability upon a railroad for having made charges that the Commission had previously approved as reasonable. The Court made it clear, however, that the Interstate Commerce Commission would be authorized to change the rate in question for future purposes. No situation like that presented in the *Arizona Grocery* case is involved here. By its order initiating the investigation, the Commission exercising the authority conferred on it by Section 220 (c) of the Communications Act, called upon the appellee to justify the accounting entries questioned by the Commission. After determining the facts and considering appellee's attempted justification, the Commission by its order directed appellee to restate its accounts so that they would accurately reflect the transactions in issue. As a matter of fact, the order of investigation initiating the proceeding did direct inquiry into the question whether the appellee or any of its officials and directors had violated the Commission's account-

ing regulations. However, this portion of the proceedings was terminated and dismissed by the Commission's final order (R. 42). Thus it is clear that the Commission's order does not in any way attempt to penalize anyone for past action, but merely requires appellee to restate its accounts prospectively in accordance with the Commission's original cost system of accounts—an authority expressly recognized by this Court in the *American Telephone and Telegraph Company* case.

III

THE COMMISSION'S ORDER IS VALID EVEN THOUGH IT APPLIES, IN PART, TO ACCOUNTING WITH RESPECT TO PROPERTY WHICH HAS ALREADY BEEN RETIRED

In addition to the two grounds relied upon by the court below in setting aside the Commission's order, appellee argued below—although this was not incorporated in the court's opinion as a ground for the injunction—that since some of the property in question has been retired, the Commission's order improperly required the entire amount of the original write-up to be eliminated from its accounts. This contention completely ignores the fact that appellee's actual accounting in connection with the property in question has not eliminated any of the original inflation from its books and that appellee's books do not at the present time accurately reflect the facts as to the condition of the company.

As has already been pointed out (*supra*, pp. 9, 10–11), when appellee acquired the property in question it entered the entire amount of the so-called purchase price for the property in its plant accounts. No amount was entered in its depreciation or amortization reserves notwithstanding that, as can be seen from the table on page 9, *supra*, the property was carried on the A. T. & T. books before the transfer at a book cost of $13,269,567.47 with related depreciation and amortization reserves of $4,801,397.66 but was recorded in appellee's plant account at $12,634,680.38 with nothing in related depreciation and amortization reserves.

Thereafter, despite the fact that the acquired property was not new, and its "purchase price" purported to reflect all existing depreciation in the property, and despite the fact that no amount had been entered by appellee in its depreciation reserve at the time of the acquisition, appellee did not apply a special depreciation rate in order to accumulate in the reserve a sufficient amount to provide for the retirement of the book cost of the property at the end of its service life. Instead, appellee merely applied the current depreciation rates which it had previously established with respect to its various classes of plant. In the case of toll property, appellee already had property of this kind on its books; it recorded the acquired toll property in these accounts and used the pre-existing depreciation rates which were applicable

to such accounts (R. 26; Tr. 121–126, 362–366, 473). So far as the acquisition in 1927 of the instruments is concerned, appellee had had no property of this kind before 1927 and, on the assumption that the service life of the instruments was the same as that of other station equipment which it previously owned, the depreciation factor applied was that which appellee had previously established for such other station equipment based upon data through the year 1925[13] (R. 26; Tr. 548–554, 558–563, 1009–1010, 1018, 1022, 1036–1048, 1140–1141). As a result, when the property reached the end of its service life, insufficient amounts had been accumulated in appellee's depreciation reserve to cover the cost of the property as carried in appellee's plant accounts.

When the property in question was retired, appellee credited its entire book cost for that property to the plant accounts and the same amount (aside from the allowance for salvage) was debited to depreciation reserve. Thus, because of the type of accounting which was followed, appellee charged to the depreciation reserve more than had been credited thereto; the excess being at least as much as the amount of the

[13] Depreciation rates are determined by estimating the total service life of property and the salvage which will remain at the end of service life. The annual depreciation rate is determined by dividing the service-life years into 100% (full book cost) minus salvage. For example, property with a 15-year service life and 10% salvage at the end of that time would carry a 6% annual depreciation rate.

original write-up with respect to that property.[14] The Commission concluded that this resulted in moving the inflation from the plant accounts to the depreciation reserve in the form of a defi-

[14] That this is so may be demonstrated by an example which, though simplified, accurately illustrates what happened in the instant case. Assume AT&T bought property at a cost of $80.00 which had an expected life of 10 years. The annual depreciation rate would hence be 10%, or $8.00 per year, assuming no salvage. If AT&T kept the property for 3 years and then transferred it to appellee for $70.00, the result would be a write-up of $14.00—the difference between $70.00 and $56.00, the net book cost of the property. Assume further that, as in the instant case, the property was recorded on appellee's books at $70.00 with nothing being recorded in the depreciation reserve, and that appellee continued to account for its depreciation at 10% of $70.00 each year. Upon the retirement of the property, only $49.00 would have been contributed to the depreciation reserve but $70.00 would have been credited to plant account and debited to depreciation reserve. Thus the deficiency in the depreciation reserve would be $21.00 or $7.00 more than the amount of the original write-up.

Similarly, in the instant case, when appellee recorded the transfers on its books at the so-called purchase price, a write-up of $4,166,510.57 resulted. Property with an original book cost of $13,269,567.47 and related depreciation and amortization reserves of $4,801,397.66 or a net book cost on the books of AT&T of $8,468,169.81 was entered in appellee's plant accounts at $12,634,680.38 with nothing entered in the depreciation or amortization reserves with respect thereto. The annual depreciation rates which appellee applied thereafter were those which had previously been determined with respect to the property of the class in question and were applied, moreover, to the 12 million rather than the 13 million figure. Thus, upon retirement of the property, none of the original write-up was removed from appellee's books.

ciency in the reserve. This conclusion is supported by testimony in the record of witnesses experienced in the field of regulation of public utility accounting (Tr. 1198–1199, 1891–1895, 1954, 1970–1973, 1986–1988; see also Tr. 1533–1534).

Appellee, in its argument before the Commission and the court below, attempted to answer this point on two grounds. In the first place, it contended that since much of the depreciation accounting followed by appellee occurred during a period before the Commission had jurisdiction over appellee's accounting, the Commission's order was an attempt retroactively to change its accounting. As has been pointed out under Point II, *supra,* the Commission has the authority to require appellee to conform its books to the Commission's System of Accounts even with respect to transactions that took place before the Commission was organized. The Commission's concern with the type of depreciation accounting followed by appellee in the past is not to require a retroactive change in depreciation rates but to show that because of the type of depreciation accounting followed by appellee, the amount of the original write-up was not removed from appellee's books as a result of the retirement of some of the property in question but presently remains in one of appellee's balance sheet accounts—depreciation reserve. If the accounting followed by appellee had left an excess in the plant account after the

retirement of property, a contention that the Commission could not require its elimination from the books would, of course, be given short shrift. A deficiency in the depreciation reserve stands on the same footing, since net book cost of property can as effectively be misstated by writing too much out of depreciation reserve as by writing too much into plant accounts.

Appellee's second argument is that it did in fact take into account the used life of the property in computing the depreciation rates for the acquired property. The record, however, amply supports the Commission's finding to the contrary. The appellee relies mainly on the testimony of one of its witnesses, Mr. Trax, who, in the course of his testimony (Tr. 365), made the general statement that consideration was given to the used character of the property but because of the fact "that there were certain other factors that were operating to extend the life of the property in almost all of the accounts which more than offset the shortening of life in a few accounts that resulted from this purchase" no increase in the depreciation rate was deemed necessary. Mr. Trax did not elaborate on this statement and no studies or data were produced to show what "the other factors" were, how they were arrived at, or other like information. It is clear from Mr. Trax's testimony, however, that what he was referring to was his view that since the overall depreciation reserve was adequate, no added depreciation was necessary because as Mr. Trax

put it (Tr. 365) "the ruling consideration always was whether the total depreciation accrual for any given period was ample * * *."[15]

That this is the correct interpretation of Mr. Trax's statement appears also from the testimony of two other witnesses called by appellee, Mr. Bradshaw and Mr. Schaffer. Mr. Bradshaw, who was the telephone company official responsible for recording the transfers of toll properties on appellee's books, testified (Tr. 121-126) that the toll property acquired from A. T. & T. was recorded in the appropriate accounts on appellee's books and that the depreciation rate which appellee had theretofore developed for that type of property was used for the acquired property. He admitted that the depreciation rate had been determined before the transfers in question and purported to represent the total of straight line depreciation for that type of property. The witness conceded that in arriving at a depreciation rate representing total straight line depreciation, the total useful life of the property is used, but that, nevertheless, the rate so derived was applied to amounts pertaining to property acquired from A. T. & T., the remaining useful life of which, the witness admitted, was less than total useful life. Mr. Schaffer, a member of the accounting firm of Lybrand, Ross Bros. and Montgomery, testified (Tr. 478–479,

[15] As will be shown later on (*infra*, pp. 49–51), this position is completely untenable.

508–509, 1527, 1532–1534) that only if "precisely adequate rates of depreciation were used" would it be possible to have the plant and reserve accounts "relieved" upon retirement of the property. He admitted (Tr. 1532), however, that in considering the depreciation rates, he did not attempt to satisfy himself "whether the depreciation with respect to a particular piece of property was adequate or not. I think that we looked at the reserve as a whole * * *." Surely, in a proceeding where appellee had the burden of proof of justifying its accounting (see *supra*, p. 23) there can be no doubt that the Commission was justified in refusing to accept, as unpersuasive, appellee's suggested interpretation of the unsupported statement of Mr. Trax in the light of these clear admissions of Mr. Bradshaw and Mr. Schaffer.

The testimony in connection with the depreciation accounting for the telephone instruments similarly supports the Commission's finding. Appellee urged below that the depreciation rates applied to the telephone instruments took into account the fact that part of the useful life of the instruments had already been consumed when the instruments were transferred. But the testimony of appellee's own witness actually contradicts this contention. As has already been pointed out (*supra*, p. 11), the instruments were not transferred to plaintiff until 1927 but appellee's wit-

ness admitted (Tr. 1037–1038) that the depreciation rates which were thereafter applied were derived from a study of data pertaining to the other parts of the telephone stations through the year 1925—before the instruments were transferred.

It seems to be clear, from the emphasis by appellee before the Commission and in the court below and the testimony in the record on which it relies, that appellee's real argument on this point is not that depreciation rates which it applied were sufficient to dispose of the write-up but, rather, that the mere fact that it debited its depreciation reserve with more than it had credited thereto is not controlling unless it can be shown that the depreciation reserve as a whole is inadequate. This is certainly a novel doctrine. What appellee is urging is that when the Commission discovers that there is an error in an entry made by a carrier in its depreciation reserve account, the Commission is powerless to require the correction of this error unless it can find that the depreciation reserve as a whole is incorrect (R. 36). The composition of the depreciation reserve of a company whose operations are as extensive as those of appellee depends upon many complex and variable factors. If, as appellee apparently suggests, the Commission may correct accounting mistakes which it finds with respect to that depreciation reserve only after it examines or reex-

amines anew in every case the overall adequacy of the depreciation reserve, the Commission would be hamstrung in the effective exercise of its power to regulate accounting. Under appellee's theory, there would be nothing to prevent it from increasing its own surplus or from making appropriations for payment into the surplus of its parent company, merely by debiting depreciation reserve—all this without any control by the Commission unless the Commission could find that such action left the depreciation reserve as a whole impaired. This would make a mockery of regulatory accounting. Cf. *United States* v. *Wabash R. Co.*, 321 U. S. 403, 414. As the Commission pointed out in its Report (R. 36):

> A forgiveness of the 1925–1928 write-ups on the ground of their elimination by charges against the depreciation reserve would be the equivalent of permission to establish corporate surplus out of accruals charged to operating expenses by a company under the guise of depreciation. New York is actually here trying to justify a transfer from its depreciation reserve to the corporate surplus of its parent, A. T. & T. New York's further contention, stated above, is in effect a claim that it can make any improper entries which would reduce its depreciation reserve, and not be required to correct such entries unless a deficiency can be proved in the reserve as a whole. This amounts to a claim,

about which no more need be said, that no individual accounting entries can be ordered to be corrected unless the Commission can prove that all the accounts involved are otherwise in order.

CONCLUSION

All the contentions which the appellee now makes were urged by it before the Commission, which carefully considered and rejected them. As the Commission's report and the supporting evidence in the record show, the Commission's determination is reasonable and is therefore to be sustained. For, as Mr. Justice Cardozo, speaking for the Court, in the *American Telephone and Telegraph* case, pointed out (pp. 236–237):

> This court is not at liberty to substitute its own discretion for that of administrative officers who have kept within the bounds of their administrative powers. To show that these have been exceeded in the field of action here involved, it is not enough that the prescribed system of accounts shall appear to be unwise or burdensome or inferior to another. Error or unwisdom is not equivalent to abuse. What has been ordered must appear to be "so entirely at odds with fundamental principles of correct accounting" (*Kansas City Southern Ry Co.* v. *United States,* 231 U. S. 423, 444) as to be the expression of a whim rather than an exercise of judgment.

See also: *Interstate Commerce Commission* v. *Goodrich Transit Co.*, 224 U. S. 194; *Norfolk & Western Ry. Co.* v. *United States*, 287 U. S. 134; *Northwestern Electric Co.* v. *Federal Power Commission*, 321 U. S. 119; *New England Telephone and Telegraph Company* v. *United States*, 53 F. Supp. 400 (D. Mass.).

Accordingly, the court below should have granted the government's motion for summary judgment and should have dismissed the complaint. *National Broadcasting Company, Inc., et al.* v. *United States, et al.*, 319 U. S. 190. The judgment of the court below should, therefore, be reversed.

Respectfully submitted.

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APPENDIX

The pertinent provisions of the Communications Act of 1934 (c. 652, 48 Stat. 1064, as amended, c. 229, 50 Stat. 189, 47 U. S. C. 151, *et seq.*) are as follows:

SEC. 220 (a). The Commission may, in its discretion, prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to this Act, including the accounts, records, and memoranda of the movement of traffic, as well as of the receipts and expenditures of moneys.

SEC. 220 (c) The Commission shall at all times have access to and the right of inspection and examination of all accounts, records, and memoranda, including all documents, papers, and correspondence now or hereafter existing, and kept or required to be kept by such carriers, and the provisions of this section respecting the preservation and destruction of books, papers, and documents shall apply thereto. The burden of proof to justify every accounting entry questioned by the Commission shall be on the person making, authorizing, or requiring such entry and the Commission may suspend a charge or credit pending submission of proof by such person. Any provision of law prohibiting the disclosure of the contents of messages or communications shall not be deemed to prohibit the disclosure of any matter in accordance with the provisions of this section.

SEC. 402 (a) The provisions of the Act of October 22, 1913 (38 Stat. 219), relating to the enforcing or setting aside of the orders of the Interstate Commerce Commission, are hereby made applicable to suits to enforce, enjoin, set aside, annul, or suspend any order of the Commission under this Act (except any order of the Commission granting or refusing an application for a construction permit for a radio station, or for a radio station license, or for renewal of an existing radio station license, or for modification of an existing radio station license, or suspending a radio operator's license), and such suits are hereby authorized to be brought as provided in that Act.

SEC. 604 (a) All orders, determinations, rules, regulations, permits, contracts, licenses, and privileges which have been issued, made, or granted by the Interstate Commerce Commission, the Federal Radio Commission, or the Postmaster General, under any provision of law repealed or amended by this Act or in the exercise of duties, powers, or functions transferred to the Commission by this Act, and which are in effect at the time this section takes effect, shall continue in effect until modified, terminated, superseded, or repealed by the Commission or by operation of law.

The pertinent provisions of the Rules and Regulations of the Federal Communications Commission (47 Code Fed. Reg. 31.01–1, *et seq.*) are as follows:

SEC. 31.01–3 (x) "Original cost" or "Cost," as applied to telephone plant, franchises, patent rights, and righ-of-way, means the actual money cost of (or the cur-

rent money value of any consideration other
than money exchanged for) property at the
time when it was first dedicated to the pub-
lic use, whether by the accounting company
or by predecessors.

SEC. 31.100:1 *Telephone plant in serv-*
ice. This account shall include the orig-
inal cost (note § 31.01–3 (x)) of the com-
pany's property used in telephone service
at the date of the balance-sheet as classified
under Accounts 201 to 277, inclusive. (Note
also §§ 31.01–3 (gg), 31.2–20, 31.2–21.)

SEC. 31.100:2 *Telephone plant under*
construction. (a) This account shall in-
clude the original cost (note § 31.01–3 (x))
of construction of telephone plant not com-
pleted ready for service at the date of the
balance-sheet. It shall include interest dur-
ing construction, taxes during construction,
and all other elements of cost of such con-
struction work. (Note also §§ 31.2–20 to
31.2–22.)

(b) When any telephone plant the cost
of which has been included in this account
is completed ready for service, the cost
thereof shall be credited to this account and
charged to the appropriate telephone plant
or other accounts.

SEC. 31.100:3 *Property held for future*
telephone use. (a) This account shall in-
clude the original cost (note § 31.01–3 (x))
of property owned and held for imminent
use in telephone service under a definite
plan for such use.

(b) The property included in this ac-
count shall be classified according to the
primary accounts for telephone plant in
service. Separate subaccounts shall be pro-
vided for this purpose which accounts shall
carry the same numbers as the plant ac-

counts except that each account number shall be prefixed by (1). (Note also §§ 31.2–20, 31.2–21.)

SEC. 31.100:4 *Telephone plant acquisition adjustment.* (a) This account shall include amounts determined in accordance with § 31.2–21 representing the difference between (1) the amount of money actually paid (or the current money value of any consideration other than money exchanged) for telephone plant acquired, plus preliminary expenses incurred in connection with the acquisition; and (2) the original cost (note § 31.01–3 (x)) of such plant, governmental franchises and similar rights acquired, less the amounts of reserve requirements for depreciation and amortization of the property acquired. If the actual original cost is not known, the entries in this account shall be based upon an estimate of such cost.

(b) This account shall be subdivided according to the character of the amounts contained therein. In addition to a copy of the journal entry recorded to open the account, the company shall file with this Commission statements showing the basis of the computation of amounts included therein. The detailed records supporting these statements shall be retained permanently by the company.

(c) The amounts recorded in this account with respect to each property acquisition shall be disposed of, written off, or provision shall be made for the amortization thereof in such manner as this Commission may direct.

SEC. 31.172 *Amortization reserve.* (a) This account shall be credited with amounts concurrently charged to Account 613,

"Amortization of intangible property," for the amortization of leaseholds, franchises, and patent rights. (Note also § 31.2–25 (e).)

(b) This account shall be credited with any amounts concurrently charged to Account 413, "Miscellaneous debits to surplus," to provide a reserve for the retirement of amounts carried in Account 201, "Organization." It shall also be credited with any amounts which this Commission may authorize under a plan to amortize the balance in Account 100:4, "Telephone plant acquisition adjustment."

(c) When any leasehold carried in Account 211, "Land," or any franchise or patent expires, is relinquished, or otherwise retired from service, this account shall be charged with the amount previously credited hereto with respect to the property going out of service. The original cost (note § 31.01–3 (x)) of the property so retired less the amount chargeable to this account and less the proceeds realized at retirement shall be included in the appropriate surplus account. (Note Accounts 315 and 174 for depreciation of miscellaneous physical property.)

Sec. 31.413 *Miscellaneous debits to surplus.* This account shall include amounts chargeable to surplus not provided for elsewhere. Among the items which shall be charged to this account are (note § 31.01–8):

Amortization, at the company's option, of the balance in Account 201.

Amortization unprovided for elsewhere.

Amounts charged to surplus to cover past accrued depreciation not provided for. (Note also Account 171.)

Amount of the debit balance in the discount, premium, and debt expense account relating to long-term debt reacquired at the time of its reacquirement. (Note § 31.1–15.)

Amount of the debit balances in the discount and premium, and stock expense accounts relating to capital stock reacquired at the time of its reacquirement. (Note § 31.1–14, also Account 134: 2.)

Amounts charged to surplus to extinguish all or any part of the debit balance in any particular discount, premium, and debt expense account for long-term debt actually outstanding. (Note § 31.1–15.)

Amounts paid for abrogation of contracts.

Appropriations to nonpar stock account. (Note § 31.1–16: 1.)

Debits resulting from adjustments required to bring to par securities issued or assumed by the company and reacquired at a cost exceeding the par value. (Note also § 31.1–13.)

Delayed debits to income, operating revenue, and operating expense accounts as provided in § 31.01–5.

Expenses incurred in connection with the reacquisition of capital stock and long-term debt. (Note also § 31.1–13 (b).)

Forfeitures of amounts deposited under options for the purchase or lease of property.

Inventory, appraisal, and other costs incident to the acquisition, sale, or lease of property where the transactions are abandoned.

Losses of funds due to bank failures.

Losses resulting from the sale, destruction, or retirement of property carried in Account 103. (Note also Account 174.)

Payments of amounts previously written off through credits to surplus.

Penalties and fines paid on account of violations of statutes pertaining to regulation.

SEC. 31.614 *Amortization of telephone plant acquisition adjustment.* This account shall be charged or credited each month with such amounts as may be authorized by the Commission to be included in operating expenses under a plan to amortize amounts in Account 100:4, "Telephone plant acquisition adjustment." Amounts so entered shall be charged or credited, as appropriate, to Account 172, "Amortization reserve."

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